BEFORE THE
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Local	)	CC Docket No. 96-98
Competition Provisions in the	)	
Telecommunications Act of 1996	)	
	)	
Inter-Carrier Compensation for	)	CC Docket No. 99-68
ISP-Bound Traffic	)	

REPLY COMMENTS OF TIME WARNER TELECOM

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Time Warner Telecom ("TWTC"), by its attorneys, hereby files these reply comments in the proceeding initiated by the Public Notice released on June 23, 2000 by the Commission in the above-captioned proceedings.

I. INTRODUCTION AND SUMMARY

Reciprocal compensation illustrates profoundly the insight that highly regulated firms like the ILECs invest too much in influencing regulatory outcomes and not enough in improving efficiency and innovation. The ILECs have gone to almost absurd lengths to try to game the rules governing the exchange of traffic in their favor. They began long before the passage of the 1996 Act, charging cellular carriers as much as three cents per minute for the exchange of traffic. When the passage of the 1996 Act was implemented, they mocked the CLEC request for bill

and keep, labeled by Bell Atlantic, in a now infamous phrase, as "bilk and keep." Figuring that CLECs needed to terminate traffic more on their networks than vice versa, and no doubt salivating at the prospect of another cellular-like boondoggle, the ILECs successfully importuned regulators to set reciprocal compensation prices far above any reasonable estimation of forward-looking cost (in most cases 4 times above their current levels).

New entrants then did what new entrants do -- they entered to serve customers with the highest margins. In many cases this meant ISPs. The CLECs realized that the ISPs had been chronically neglected by the ILECs, denied collocation rights, and generally discriminated against in favor of the ILEC affiliated ISPs. The ISPs probably would have switched to CLECs anyway. But at least some CLECs responded to the especially strong allure of above-cost reciprocal compensation rates. They also introduced significant efficiencies, such as allowing ISPs the right to collocate near CLEC switches, and generally provided ISPs with customer service far superior to the ILECs.

Rather than try to win back the ISPs, many of which were actually paying ISDN PRI prices to CLECs in the same range as the ILECs' tariffed offerings, the ILECs did what they do best: they sought to change the regulations. They begged and cajoled regulators to put a stop to the so-called reciprocal compensation

"gravy train," claiming that they were being forced to helplessly stand by while CLECs absconded with millions of dollars of ill-gotten gains. They succeeded in convincing the Commission to adopt a literalist construction of Section 251(b)(5) which was so flawed that it could not even survive the highly deferential standard for reviews of agency constructions of ambiguous statutory terms. In the meantime, state regulators began the hard work of lowering reciprocal compensation to forward-looking ILEC costs and ordered the ILECs to pay that rate for the exchange of ISP-bound calls.

Undeterred, the ILECs are now back at the Commission in this remand proceeding posing as standard-bearers for efficient competition and as champions of the intent of Congress in passing the 1996 Act. But their true goal is to convince the Commission to adopt legal and policy arguments that will undermine competition and further entrench their market power. They have asked the Commission to eliminate reciprocal compensation for ISP customers even though termination of ISP-bound traffic imposes costs on LECs that serve ISPs and even though ISP-bound traffic is highly imbalanced in favor of termination.

The Commission must reject this absurd proposal, and establish a viable framework for local competition for ISPs. First, it should rule that the term "termination" in Section

251(b)(5), is a term of art meaning the delivery of call to a non-carrier party. It should reject the ILECs' attempts to resuscitate the end-to-end analysis as applicable to Section 251(b)(5), because that analysis would lead to the insupportable result that no compensation would be due for the exchange of ISP-bound traffic, it would be inconsistent with the fact that ISP-bound traffic is telephone exchange service, and it would be inconsistent with the end user status of ISPs.

Furthermore, the Commission should reject the ILECs' meritless policy arguments in favor of abandoning reciprocal compensation of any kind for ISP-bound traffic. In a declaration attached as an exhibit to these reply comments, Don Wood, an analyst with extensive experience in analyzing telecommunications carrier costs as well as regulatory issues, provides a comprehensive refutation to the ILECs' arguments. As Mr. Wood explains, while the ILECs complain in nearly endless diatribes that reciprocal compensation causes inefficient behavior, this is simply wrong. Only reciprocal compensation rates that are not based on forward-looking costs result in inefficient behavior. Most importantly, there is no evidence to support the ILECs' assertions that reciprocal compensation based on ILEC forward-looking costs exceed CLEC terminating costs. The only situations where this might be the case is with firms that have entered

solely to game the regulatory process. These outliers should not be the basis for eliminating competition for ISP customers; they should instead be eliminated from reciprocal compensation entirely by appropriate state action.

More generally, the Commission must recognize that the ILECs' assertions regarding CLEC business practices are empty and misleading rhetoric. The ILECs imply that CLECs serving ISPs have no interest in building networks or serving other customers. This is simply wrong. TWTC, for example, is a facilities-based provider that targets the full array of business customers in the cities in which it operates. Only approximately ten percent of TWTC's customers are ISPs. Those ISPs pay TWTC ISDN PRI prices that are very close to the ILEC prices. But ISPs subscribe to TWTC service because TWTC provides superior service quality. TWTC cannot continue to do so however, if it is not compensated for the costs it incurs in terminating traffic to its ISP customers.

In sum, the exchange of ISP-bound traffic should be priced at a level that encourages marketplace competition. ILECs must be forced to win ISPs back by investing in improved customer service and innovation, not by investing in lawyers and lobbyists.

II. THE ILECS PROVIDE NO LEGAL BASIS FOR ELIMINATING RECIPROCAL COMPENSATION FROM THE EXCHANGE OF ISP-BOUND TRAFFIC.

In its initial comments, TWTC explained that the Commission should construe the word "termination" in Section 251(b)(5) as a term of art, consistent with industry usage, meaning delivery of a call to a non-carrier party. This termination functionality has no bearing on the end point of the call for jurisdictional purposes. In the case of reciprocal compensation, as the D.C. Circuit concluded, an ISP is the "called party" when a subscriber establishes a dial-up connection. Thus, when an ISP subscriber calls an ISP within the same local calling area, reciprocal compensation should apply. This approach is consistent with the D.C. Circuit's opinion, the end user status of ISPs, and the Commission's definition of termination is Section 51.701(d) of its rules.

In their comments, the ILECs offer an array of legal arguments to try to support the elimination of compensation for the transport and termination of ISP-bound traffic. None of these arguments has merit.

A. The End-To-End Analysis Should Not Be Used To Determine The Termination Point Of ISP-Bound Traffic.

The D.C. Circuit held that the Commission had not provided an adequate explanation as to why it was reasonable to apply the end-to-end analysis to determine the point of termination for

Section 251(b)(5) purposes. Bell Atlantic v FCC, 206 F.3d 1, 8 (D.C. Cir. 2000) The ILECs now all assert that the D.C. Circuit was unduly concerned about the application of the end-to-end analysis in this context, since the Commission has in the past applied that analysis in cases involving information service providers and even to determine regulatory issues other than jurisdiction. See USTA White Paper at 8-10; Verizon Comments at 8-9; Qwest Comments at 3-5, 9. But these cases cannot bear the burden the ILECs ask of them.

As a preliminary matter, the issue in this proceeding is not whether the Commission can apply the end-to-end analysis to determine the jurisdiction of telecommunications comprised of both a telecommunications service (the local service connection between the ISP subscriber and the ISP) and an information service (the connection to the Internet). It clearly may. The question here is whether that methodology should be used to determine whether telecommunications terminates for purposes of reciprocal compensation. Indeed, as the D.C. Circuit stated, "[e]ven if the difference between ISPs and traditional long-distance carriers is irrelevant for jurisdictional purposes, it appears relevant for purposes of reciprocal compensation." Bell Atlantic v. FCC, 206 F.3d at 6.

Furthermore, although the Commission has in the past applied the end-to-end analysis for purposes other than determining jurisdiction (such as whether access charges apply), that hardly makes it reasonable to apply that analysis to reciprocal compensation under the 1996 Act. A construction of a statutory provision, although conceivable in a vacuum, must be rejected if it is inconsistent with legislative intent or leads to absurd results.[1] This is clearly the case here.

There are only two available intercarrier compensation mechanisms available for ISP-bound traffic: reciprocal compensation and access charges. The Commission has construed Section 251(b)(5) to apply only to local traffic and has held that ISPs do not pay access. Given this context, it would be absurd and contrary to congressional intent to apply the end-to-end analysis to determine which traffic is subject to reciprocal compensation. This is because the end-to-end analysis would classify ISP-bound traffic as non-local, thus precluding intercarrier compensation and preventing competition for serving ISPs. It is simply implausible to conclude that Congress intended

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[1] See United States v. Bryan, 339 U.S. 323, 338 (1950); Lange v. United States, 443 F.2d 720, 722-23 (D.C. Cir. 1971) ("The literal wording of the statute is a primary index but not the sole index to legislative intent. It cannot prevail over strong contrary indications in the legislative history or so as to command an absurd result.").

that the 1996 Act would leave out of its competitive scheme a large category of customers such as ISPs.

The ILECs' construction of Section 251(b)(5) is highly reminiscent of the long distance carriers' attempt to construe that same provision as replacing the interstate access charge regime. The pre-1996 Act definition of "access service" is strikingly similar to the language of Section 251(b)(5). It is as follows:

> *Access Service* includes services and facilities provided for the origination or termination of any interstate or foreign telecommunication.

47 C.F.R. § 69.2(b). Section 251(b)(5) covers the "transport and termination of telecommunications" and therefore could have been read to subsume and replace the regulatory "access service" definition. In the 1996 local competition proceeding, the long distance carriers argued for just this interpretation. But the ILECs argued, and as the Commission agreed, that such a construction of Section 251(b)(5) would lead to the absurd result of eviscerating overnight the interstate access charge regime.[2] In the instant proceeding, the ILECs are now proposing a

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[2] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, First Report and Order, 11 FCC Rcd 15499, ¶ 1034 (1996) (Local Competition Order).

construction of Section 251(b)(5) that leads to equally absurd results (the elimination of any compensation for the exchange of ISP-bound traffic), but ones that benefit the ILECs. This is hardly a reason to accept the ILECs' argument.

Furthermore, in the pre-1996 Act access cases cited by the ILECs, the Commission was not applying its definition of Section 251(b)(5) "termination" -- "the delivery of [local] traffic to the called party's premises." 47 C.F.R. § 51.701(d). If the Commission had meant to incorporate the end-to-end jurisdictional analysis used in the pre-1996 access charge cases into the term "termination" it could have said so. But it wisely did not. The "delivery" of a call to the "called party's premises" is appropriately flexible terminology, which allows the Commission to apply the term termination in a reasonable way given the goals of the 1996 Act and given that the 1996 Act is "in many important respects a model of ambiguity or indeed even self-contradiction." AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 397 (1999). Clearly, a rigid application of the end-to-end approach to determine the meaning of "termination" would prevent this result.

The Commission must also reject SBC's assertion that "section 51.701(d) of the Commission's rules does not purport to define which calls are subject to reciprocal compensation" but rather "merely gives a definition of 'termination' that pertains

to whatever traffic is local and hence subject to reciprocal compensation." SBC Comments at 20. Courts grant regulatory agencies heightened discretion when construing their own rules.[3] The Commission should use this discretion to clarify that its definition of termination dictates the point of termination, not merely the functionalities to be considered when setting the price for transport and termination. Indeed, any other construction of this rule could again lead to absurd results. If the point of termination is reached using network facilities other than those listed in the definition of termination, there could well be a disconnect between termination prices and the actual termination functions performed. Prices would not be based on cost -- precisely the problem that the ILECs complain about so strenuously in this proceeding.[4]

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[3] See Capital Network System, Inc. v. FCC, 28 F.3d 201, 206 (D.C. Cir. 1994).

[4] TWTC's construction of "termination" does not mean that the use of that term in the definition of "exchange access" codified in the 1996 Act overturns the pre-1996 Act cases in which the Commission applied the end-to-end analysis to determine whether access charges applied. The definition of "termination" adopted by the Commission in the reciprocal compensation context could easily be applied in the access context to reach the same results as were reached in the pre-1996 Act access charge context. In other words, the Commission has the discretion to determine who is the "called party" in any given case (although it must obviously be consistent). In many, if not most, cases the point of delivery of traffic to the "called party" will also be the

Nor should the Commission rely on its analysis in the Advanced Services Remand Order, as the ILECs suggest, in this proceeding.[5] In that case, as in the Declaratory Ruling, the Commission relied on the end-to-end analysis to determine whether traffic is local or long distance.[6] But in so doing, the Commission held that "exchange access," which is the provision of services and facilities "for the purpose of origination and termination of telephone toll service" includes ISP-bound traffic. It reached this conclusion based on the fact that ISPs purchase underlying toll service over which their information services travel. Advanced Services Remand Order, ¶ 36. But the Commission has stated that telecommunications service (of which telephone toll traffic is an example) and information service are mutually exclusive classifications. See Federal-State Joint Board on Universal Service, Report to Congress, 13 FCC Rcd 11501,

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end point for jurisdictional purposes. But this should not be the case where this equivalence would lead to absurd results that run counter to the goals of the 1996 Act.

[5] See Deployment of Wireline Services Offering Advanced Telecommunications Capability, Order on Remand, 15 FCC Rcd 385 (1999) (Advanced Services Remand Order).

[6] See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Inter-Carrier Compensation for ISP-Bound Traffic, Declaratory Ruling in CC Docket No. 96-98 and Notice of Proposed Rulemaking in CC Docket No. 99-68, 14 FCC Rcd 3689 (1999) (Declaratory Ruling).

¶ 59 (1998). A communication cannot be telecommunications service and information service at the same time, and a LEC cannot terminate telecommunications service and information service at the same time. ISP-bound traffic is unquestionably an information service. The Commission therefore incorrectly (as the ILECs themselves argued before the Commission and are now arguing on appeal) found that ISP-bound traffic can be access in the Advanced Services Remand Order.

Importantly, the Commission's incorrect conclusion in this regard was largely dictated by its conclusion in the Declaratory Ruling that the end-to-end analysis must be applied and that ISP-bound traffic is therefore not local traffic. After the Declaratory Ruling, the Commission had no choice but to find a way to classify as exchange access ISP-bound traffic that is destined for points beyond the ISP. Otherwise, Section 251(c) obligations might not apply to advanced services. The D.C. Circuit has now vacated the Declaratory Ruling, and strongly indicated that the Commission can conclude that interstate ISP-bound traffic may be local for purposes of reciprocal compensation. The Advanced Service Remand Order can therefore be revisited. The Commission can classify xDSL services carrying traffic to ISPs as local without losing jurisdiction over those

services and without causing havoc in the competitive market for dial-up connections to ISPs. The Commission should do so.

Finally, the ILECs are also wrong when they assert that failure to apply the end-to-end analysis to reciprocal compensation will result in a violation of Section 201. See SBC Comments at 13. Section 251(i) states that "[n]othing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201." The ILECs argue that subjecting the exchange of ISP-bound traffic to reciprocal compensation would give the states the right to set final rates for the exchange of ISP-bound traffic, thus limiting the FCC's authority under Section 201 in violation of Section 251(i). But ever since it classified ISPs as users of telecommunications service rather than providers of those services, the Commission has allowed states to set the prices applicable to traffic carried between ISPs and their subscribers. This has always been understood to be a necessary and fully permissible consequence of the end user status of enhanced/information service providers. See Southwestern Bell Tel. Co. v. FCC, 153 F.3d 523, 542-543 (8th Cir. 1998). Applying Section 251(b)(5) to the exchange of ISP-bound traffic would merely apply this approach to the situation where two LECs combine to deliver traffic to ISPs. As has always been the case, however, the Commission would retain the authority

to classify ISPs as carriers subject to carrier access charges. In this way it could exclude interstate ISP-bound traffic from reciprocal compensation if it wished to eliminate any state role in regulating that traffic.

B. ISP-Bound Traffic Is Telephone Exchange Service.

Several parties in this proceeding argue that it does not matter whether the Commission classifies ISP-bound traffic as telephone exchange service, exchange access or any other type of traffic, since the key issue in this proceeding is the "termination" point of ISP-bound traffic. But this is incorrect. Under the relevant statutory and regulatory definitions, all traffic that "terminates" within the local exchange and constitutes telephone exchange service must also be local for reciprocal compensation purposes.

The Commission has conceded that ISP-bound traffic must either be telephone exchange service or exchange access service. See Bell Atlantic v. FCC, 206 F.3d at 8. As explained, ISP-bound traffic cannot be exchange access. On the other hand, ISP-bound traffic fits comfortably within the definition of telephone exchange service. That definition speaks in terms of "intercommunicating service" -- the ability of each subscriber to reach the other subscriber-- within a local calling area or "comparable service provided through a system of switches,

transmission equipment, or other facilities (or combination thereof) by which a subscriber can originate and terminate a telecommunications service." 47 U.S.C. § 153(47). As TWTC explained in its comments, service purchased by ISP subscribers and ISPs out of state local telephone service tariff offerings provides just this kind of intercommunicating service. See TWTC Comments at 11.

Furthermore, the term "termination" is used in the definition of telephone exchange service, exchange access and in Section 251(b)(5). The Commission is bound by the presumption that it must construe this term in all of these closely related statutory provisions in a manner that is consistent and reasonable.[7] The way in which the point of "termination" is determined under the definition of "telephone exchange service" must, for example, be consistent with the way in which the point of "termination" is determined under the definition of reciprocal compensation.

Telephone exchange service and local service for reciprocal compensation purposes both include only calls that originate and

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[7] See Atlantic Cleaners & Dyers v. United States, 286 U.S. 427, 433 (1932) ("Undoubtedly, there is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning."); Martini v. Fed. Nat'l Mortgage Ass'n, 178 F.3d 1336, 1343 (D.C. Cir. 1999).

terminate within the same local calling area. As mentioned, the definition of telephone exchange service is intercommunicating service "within a telephone exchange" or "comparable service" by which subscribers "can originate and terminate a telecommunications service." 47 U.S.C. § 153(47). Thus, telephone exchange service provides the ability to originate and terminate traffic within the same local calling area. Similarly, telecommunications traffic "that originates and terminates within a local exchange area" is "local" for reciprocal compensation purposes under Section 51.701(b)(1) of the Commission's rules.

Again, termination must be construed in a consistent fashion. It follows, that if a call terminates at a point that qualifies it as a telephone exchange service call, it also constitutes a local call for reciprocal compensation purposes. That is, if ISP-bound traffic is telephone exchange service, it must be local for purposes of reciprocal compensation.

C. Failure To Apply Reciprocal Compensation To The Exchange Of ISP-Bound Traffic Is Inconsistent With The End User Status Of ISPs.

The ILECs' strained attempts to make their proposed non-local treatment of ISP-bound traffic consistent with the end user status of ISPs are also meritless.

To begin with, the ILECs assert that the Commission has only classified ISPs as end users for access purposes and that there

is no reason why they could not be treated differently in the reciprocal compensation context. In fact, however, the Commission has treated ISPs (like all information service providers) as end user, non-carriers in every relevant respect. ISPs do not pay universal service fees;[8] they do not pay carrier access charges and are otherwise not subject to common carrier regulation;[9] and they do not have the rights of telecommunications carriers under Section 251.[10] It would

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[8] See Federal-State Joint Board on Universal Service, Report and Order, 12 FCC Rcd 8776, ¶ 788 (1997) ("Furthermore, we agree with the Joint Board that information service providers (ISP) and enhanced service providers are not required to contribute to support mechanisms to the extent they provide such services.").

[9] See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges, First Report and Order, 12 FCC Rcd 15982, ¶ 345 (1997) (Access Charge Order).

[10] See Local Competition Order, at ¶ 995 ("In addition, we conclude that enhanced service providers that do not also provide domestic or international telecommunications, and are thus not telecommunications carriers within the meaning of the Act, may not interconnect under section 251.").

The fact that the Commission has classified ISPs as end users for *all* purposes should resolve the matter. Nevertheless, the ILECs' attempts to show that ISPs are not just like other business users are unconvincing. Qwest, for example, asserts that ISPs are different from other business customers because "the calls that ISPs receive are not simply incidental to the services they provide; rather they are an integral part of the very product the ISP is providing." Qwest Comments at 9. But this could also be said of the service offered by credit card verification systems and bank account information services. See Bell

therefore constitute a dramatic departure from Commission precedent to treat ISPs as something other than end users for reciprocal compensation purposes.

Moreover, ILEC attempts to fit calls to ISPs into the access charge model -- in which the LEC handing traffic to the IXC pays the LEC serving the end user -- rather than the reciprocal compensation model -- in which the LEC terminating traffic to the ISP is compensated for the cost of this service by the originating LEC -- are simply inconsistent with the broader regulatory treatment of ISPs. As the Commission has explained, there are two possible scenarios in which local carriers exchange traffic:

> Access charges were developed to address a situation in which three carriers -- typically, the originating LEC, the IXC, and the terminating LEC -- collaborate to complete a long distance call. As a general matter, in the access charge regime, the long-distance caller pays long-distance charges to the IXC, and the IXC must pay both LECs for originating and terminating access service. By contrast, reciprocal compensation for transport and termination of calls is intended for a situation in which two carriers collaborate to complete a local call. In this case, the local caller pays charges to the originating carrier, and the originating carrier must compensate the terminating carrier for completing the call.

> Atlantic v. FCC, 206 F.3d at 7. That such services are offered by firms that also sell other services seems hardly a basis for distinction.

Local Competition Order, ¶ 1034. There should be no question that the exchange of ISP-bound traffic falls within the reciprocal compensation model. Local rates paid by ISP subscribers are set at a level to ensure recovery of all subscriber-originated calls to telephone numbers within the local calling area. This includes calls to ISPs. It is for this reason that the costs associated with interstate ISP-bound dial-up connections are allocated to the intrastate jurisdiction. Declaratory Ruling, ¶ 23. In this situation, it makes sense for the originating LEC to pay the terminating LEC because the originating LEC has already received payment for originating and terminating the call. The terminating LEC is unable, as a practical matter, to recover the costs of transport and termination from its subscriber because doing so would result in that LEC charging rates above competitive levels.

ILEC arguments to the contrary are easily rejected. First, the ILECs assert in conclusory fashion that ISP-bound traffic must be access because it is part of a larger interstate communication. See USTA White Paper at 11. But this argument ignores the fact that, as the D.C. Circuit recognized, termination in Section 251(b)(5) is not necessarily the jurisdictional end point.

Nor is the ILEC argument that ISP-bound traffic resembles Feature Group A traffic any more convincing. See USTA White Paper at 11; Qwest Comments at 11. Feature Group A, and all other forms of interstate access, are very different from the local call scenario described above. The costs incurred by an ILEC to deliver traffic to the purchaser of an interstate access service (including Feature Group A) are not allocated to the intrastate jurisdiction and are not recovered by the local service charge. They are allocated to the interstate jurisdiction and recovered from the IXC, the purchaser of the interstate access service. Where a LEC provides the interstate access service, the access purchaser pays the LEC with whom it has a customer relationship for the cost of carrying the traffic. It therefore makes sense that the LEC with a customer relationship with the access purchaser should split its access revenues with a LEC serving the access purchaser's customer. But, as explained, this kind of intercarrier payment system is not appropriate for ISP-bound traffic.

The ILECs also cannot explain away the FCC's reliance of the technical differences between long distance carriers and ISPs as one of the bases for treating ISPs as end users. The ILECs emphasize that in the Access Charge Order passage relied upon by the D.C. Circuit, the Commission merely stated that "it is not

clear" that ISPs and long distance carriers use the network in the same way. But the ILECs gloss over the fact that the Commission subsequently convinced the Eighth Circuit Court of Appeals that the continued treatment of ISPs as end users rather than purchasers of access was reasonable based in large measure on the fact that ISPs utilize local networks differently than IXCs do. See Southwestern Bell Tel. Co. v. FCC, 153 F.3d at 542-544. The Commission may not now reach a different conclusion without conducting a comprehensive review of the ISP business, something that is certainly not appropriate in this proceeding.

III. THE ILECS FAIL TO PROVIDE A POLICY BASIS FOR ELIMINATING RECIPROCAL COMPENSATION FROM THE EXCHANGE OF ISP-BOUND TRAFFIC

The ILECs are as weak on public policy as in they are on the law. While they offer an array of overstated and generally irrelevant public policy arguments, none of them can change the fundamental realities of ISP-bound traffic. That traffic is carried over the same facilities as other circuit-switched traffic. Terminating LECs unquestionably incur incremental costs when delivering traffic to ISP customers. There is every reason to believe that those costs are in line with forward-looking cost estimates for circuit-switched traffic. When the terminating LEC performs termination on behalf of an originating LEC, it must be compensated for that service because otherwise the originating

LEC will experience a windfall in the form of avoided terminating costs and, more importantly, the terminating LEC will not be able to serve ISPs. Therefore, the same reciprocal compensation rates that apply to all other circuit-switched local traffic should also apply to the exchange of ISP-bound traffic.

Notwithstanding these simple and dispositive facts, the ILECs argue that applying reciprocal compensation to the exchange of ISP-bound traffic is bad policy. They argue that reciprocal compensation should not apply at all to ISP-bound traffic or, as a proxy, that it should not apply to any traffic beyond certain ratios of traffic imbalance (e.g., 2:1). The ILECs justify the complete or virtual prohibition on reciprocal compensation for ISP-bound traffic based on their assertions that (1) it is one-way traffic, (2) the costs of terminating ISP-bound traffic are lower than other traffic, especially for CLECs, (3) CLECs do not need reciprocal compensation because they should and can recover their transport and termination costs from ISPs, (4) it reduces competition for residential customers, (5) it reduces incentives of CLECs and ISPs to deploy advanced services, (6) it gives CLECs and ISPs the incentive to engage in inefficient regulatory "scams," (7) it causes irrational pricing schemes, (8) it prevents ILECs from serving ISPs, even when they are more efficient, (9) it leads to undesirable changes in local rate

levels and structures, and (10) application of reciprocal compensation could undermine the U.S. positions taken before the International Telecommunications Union ("ITU"). These arguments are far more numerous than credible. In fact, each is easily rejected.

First, SBC argues that the theory behind reciprocal compensation, that end users only pay for traffic that they originate but not traffic they receive, does not apply to ISPs because ISPs only receive traffic. SBC Comments at 29. ISPs only purchase termination service, so the argument goes, and therefore the terminating carrier must be recovering the costs of termination from its ISP customer. But this is simply not correct. ISPs generally subscribe to business lines, including ISDN PRI lines. The price of these lines includes a flat monthly charge to cover the non-usage sensitive cost of connecting the ISP to the LEC's switch and a usage-based charge for calls originated by the customer. Unless they originate traffic, ISPs pay CLECs only the flat charge which covers the fixed costs of the connection to the CLEC switch. The flat monthly charges do not cover the incremental cost of terminating traffic to the ISP (or indeed originating traffic -- those are recovered through

usage-based rates).[11] Reciprocal compensation must therefore be paid for the termination function.

Second, the ILECs claim that CLEC costs in terminating ISP-bound traffic are lower than even true forward-looking reciprocal compensation rates for all circuit-switched traffic. See, e.g., Verizon Comments at 22-27, Taylor Dec. at ¶¶ 24-35; SBC Comments at 32-37. But as explained in the attached Declaration by Don Wood, a highly experienced telecommunications analyst ("Wood Dec."), there is no basis for this assertion. See Wood Dec. at ¶¶ 19-32. The fact is, CLECs use the same switching facilities and funtionalities to transport and terminate ISP-bound traffic as all other traffic. These facilities and functionalities do not mysteriously become less costly because they are used to carry calls of longer duration.

Specifically, none of the factors identified by William Taylor in the declaration filed by Verizon actually results in lower ISP termination costs for CLECs. Contrary to Dr. Taylor's

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[11] For the same reason, SBC's reliance on the Commission's statement in the Access Charge Order (at ¶ 346) that ILECs can recover costs associated with ISP traffic from ISPs is misplaced. The Commission did not mean that ILECs recover the usage sensitive costs carrying ISP-bound traffic from ISPs, but rather the cost of establishing ISP-to-switch connections. Thus, the Access Charge Order cannot be read, as SBC asserts, to justify the elimination of reciprocal compensation for ISP-bound traffic.

assertions, the fact that calls to ISPs are longer does not make CLEC termination costs cheaper unless the call set-up costs have been incorrectly allocated to usage-sensitive charges. See id. at ¶¶ 20-21. The answer to this problem is, as Sprint has suggested, to make sure that call set-up costs are recovered efficiently. See Sprint Comments at 2-3. The ILECs' assertion that the use of ISDN PRI lines lowers the incremental cost of termination because switching capacity is dedicated to PRI lines is also incorrect. This is because (as Telcordia has recognized) the switching capacity dedicated to the PRI lines is by definition usage-sensitive. See Wood Dec. at ¶¶ 23-26. If anything, the significant dedicated switching capacity needed for PRI lines likely increases the cost of termination. See id. Dr. Taylor's assertion that TELRIC studies set prices too high because they often average originating and terminating costs is irrelevant. Termination rates should simply be changed to reflect termination costs. See id. at ¶ 27.[12] Finally, Dr. Taylor assumes that ISP-bound traffic is carried during non-peak

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[12] In a variation on this argument, SBC asserts that the originating functions of a switch are not needed to terminate calls, thus making CLEC termination costs lower. But this logic is flawed since the distinction between call origination and termination costs has no relevance to call termination costs for ISP vs. non-ISP traffic. See id. at ¶ 51.

usage periods. But this is nothing more than empty conjecture. See id. at ¶¶ 28-29.

Other ILEC arguments regarding CLEC termination costs are similarly unavailing. For example, the ILECs' tired argument that ISP collocation at CLEC switches lowers transport and termination costs is simply wrong. Collocation only lowers the fixed costs of connecting customers to the CLEC switch. These costs are not relevant to the incremental costs of transport and termination. See id. at ¶ 48. It should be noted, of course, that the ILECs' refusal to allow ISPs to collocate at their switches, while not affecting transport and termination, has made ILECs far less efficient providers of service to ISPs. It would be bitterly ironic for the Commission to now incorrectly punish CLECs for being more efficient in this regard.

Furthermore, lest any conceivable assertion go unstated, SBC also argues that the ILEC tandem rates (which are of course relatively low) should be the basis for CLEC termination costs. See SBC Comments at 33. The fact is, however, that the switches deployed by TWTC and other CLECs perform a wide range of functions not performed by ILEC tandems. See Wood Dec. at ¶ 32. The two are apples and oranges and cannot be priced similarly.

The ILECs also worry that CLECs may be busy deploying new and innovative switching technology that allows them to use some

form of "termination only" capability. See, e.g., SBC Comments at 34-35; Verizon Comments at 23-25. As this technology becomes deployed, firms that are otherwise legitimate CLECs under state law should be permitted to benefit from the increased efficiency the new equipment delivers. Indeed, the ILECs themselves might consider such innovation as a means of improving the service they offer ISPs. Of course, innovations such as these should eventually be reflected in forward-looking prices for reciprocal compensation. In the meantime, innovative firms should be rewarded for lowering their cots. If, however, reciprocal compensation prices remain above cost as a result of the ILECs' recent successful appeal of the FCC's TELRIC rules, then the ILECs have only themselves to blame.[13]

Third, the ILECs argue that the costs incurred by LECs that serve ISPs are more appropriately and efficiently borne within the contractual relationship between ISPs and their subscribers. Taylor Dec. at ¶¶ 13-23; Qwest Comments at 17. That is, the ILECs argue that ISPs should bear the costs of termination and

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[13] The Commission also need not give any credence to SBC's attempted reliance on a Texas PUC study for the proposition that CLEC ISP-bound traffic termination costs are lower than the costs SBC incurs to terminate all traffic. The Texas Commission itself has disavowed that study as a basis for differentiating ISP-bound traffic from voice traffic. See Wood Dec. at ¶ 53.

should then pass those costs along to their ISP subscribers in the form of higher subscription charges. To begin with, this argument cannot be squared with the end user status of ISPs. As explained above, that regulatory treatment of ISPs mandates that the costs of termination be recovered by the terminating LEC from the originating LEC. Otherwise, the terminating LEC would subsidize the originating LEC (a result the ILECs obviously desire). In any event, as Don Wood explains, the ILECs are wrong even as to cost causation. See Wood Dec. at ¶¶ 7-18.

Fourth, there is no basis for the ILECs' absurd assertion that efficient, forward-looking reciprocal compensation rates discourage residential competition. See, e.g., Verizon Comments at 11-14; SBC Comments at 40. If efficient reciprocal compensation rates are set, CLECs will not have the incentive to keep reciprocal compensation revenues high by not serving potential ISP dial-up subscribers.

But even in the presence the above-cost reciprocal compensation rates that the ILECs convinced the states to adopt, it cannot be said that reciprocal compensation has prevented residential competition from developing. As Verizon admits, reciprocal compensation is a small part of CLEC revenue, likely comprising only 6% this year of average CLEC revenue. Verizon Comments at 21. Furthermore, many of the major CLECs do not even

have significant reciprocal compensation revenue. See Credit Suisse First Boston, "Telecommunications Services: CLECs" (June 14, 2000) (listing Winstar, Teligent, RCN, NEXTLINK and McLeodUSA as having no reciprocal compensation revenues). They therefore would have no reason to avoid serving residential customers.

In fact, the central reason competition has not developed extensively for residential competition is that the margins for serving business customers are higher. As the Commission has recognized,

> The observation that competitive entry will occur in some places, and for some services, more rapidly than others is a corollary to the rule that firms in competitive markets seek to maximize their profits. To maximize profits, firms naturally seek out those customers and services on which they can generate the most profits. Therefore, some customers are naturally more desirable than others at any given point in time. As competitors attempt to gain the patronage of the customers offering the greatest profit opportunities, they offer lower-priced or more desirable services. These actions have the effect of reducing over time the profitability of serving those particular customers and, as this occurs, the relative profitability of serving other customers or offering other services increases. Therefore, competitors begin seeking to service these other customers, and entry occurs in new places, or for new services.

Access Charge Order, ¶ 266, n.349 (citations omitted). The Commission never expected residential competition to develop quickly. Unfortunately, this process has been slowed further than anticipated because the ILECs have so successfully resisted providing potential residential service entrants with the inputs,

such as UNEs and collocation, that they need to compete. Indeed, in many states, ILECs have convinced regulators to set unbundled loop rates above the ILEC's tariffed residential local service price.

But notwithstanding all of the obstacles, residential competition is in fact developing. Carriers are investing heavily in deploying the networks needed to offer residential customers competitive services. For example, AT&T has made enormous investments to compete in the residential market, including its acquisitions of TCI and MediaOne. AT&T is already serving over 555,000 residential lines nationwide using UNE-P, local resale, cable telephony, fixed wireless and its own facilities to multi-dwelling units.[14] Both WorldCom and Sprint are actively pursuing residential customers in New York and Texas.[15] In addition, WorldCom and Sprint have purchased several

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[14] Letter from Stephen Garavito, General Attorney, AT&T, to To-Quyen Truong, Associate Chief, FCC Cable Services Bureau, dated May 24, 2000; see also Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from MediaOne Group, Inc., Transferor, to AT&T Corp., Transferee, Memorandum Opinion and Order, 15 FCC Rcd 9816, ¶ 133 (2000) (In addition to the 555,000 AT&T residential customers, at the time of the AT&T-MediaOne merger, MediaOne had approximately 100,000 local telephone service customers of its own.).

[15] See MCI WorldCom Says Its Profit Soared 80%, N.Y. Times, April 28, 2000, at C8 ("During the quarter, MCI WorldCom said it added about 100,000 local residential customers in

MMDS systems, investing over $1 billion collectively, to provide local residential service using fixed wireless technology.[16] Residential customers are also being targeted by new entrants, such as Sage and McLeodUSA.[17] Perhaps the strongest force in residential competition will be cable overbuilders. Cable overbuilders, such as RCN, are building their networks to provide integrated packages of voice, video and broadband to residential customers.[18]

Fifth, the argument that reciprocal compensation diminishes the incentive of ISPs to purchase more efficient technology than

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New York State, giving it a base of about 300,000 customers there."); Stewart Ain, Phone Companies' Competition Heats Up, N.Y. Times, July 16, 2000, § 14LI, at 3 (reporting that Sprint has begun offering residential local service in New York); Dwight Silverman, Residential Service Set By Sprint, Houston, 4 Other Cities Will Receive Offers First, Houston Chronicle, March 25, 2000, Business Section, at 1 (reporting that Sprint is providing residential local service in Texas).

[16] See Federal Communications Commission, Broadband Today at 30 (Cable Services Bureau, rel. Oct. 1999).

[17] See Jennifer Files, Telecom Act at the Root of Four Firms, Dallas Morning News, February 6, 2000, at 1H ("80 percent of Sage's customers are residential."); Kristi Arellano, Phone Competitor Calls on Denver, McLeodUSA Wants Residential Niche, Denver Post, July 13, 2000, at C-01 (reporting that McLeodUSA is offering residential service in Denver).

[18] See New Broadband Players Rush Into Cable and Telecom Markets, Communications Daily, June 9, 2000 ("Wall St. is pouring money into new breed of [broadband service providers]").

ISDN lines designed to receive dial-up connections (see, e.g., Verizon Comments at 14-15) is simply a restatement of the ILECs' longstanding complaint that the end user status of ISPs distorts ISPs' incentives. The ILECs have for many years claimed that the exclusion of the ISPs from the interstate carrier access regime causes dial-up connections to be artificially underpriced, thus giving ISPs little incentive to purchase more efficient technology. This proceeding is not the place to resolve this issue, and in any event reciprocal compensation is irrelevant to its resolution. So long as reciprocal compensation is set at efficient prices, reciprocal compensation will not give ISPs any more incentive to retain dial-up connections than they already have.

But there is no evidence that broadband deployment is being slowed by the effects of dial-up prices. CLECs, even those most dependent on reciprocal compensation, are deploying DSL and packet-switched services for which they receive no reciprocal compensation. For instance, Adelphia has invested in cable systems through which it provides residential and small businesses an alternative to dial-up Internet access with high speed one-way hybrid service or two-way cable service.[19] Focal is

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[19] See Adelphia Communications Corp. 10-K, March 30, 2000 at 5-6; Credit Suisse First Boston, "Telecommunications Services:

deploying DSL to meet its customers demands.[20] Intermedia offers a wide range of packet-switched services to its customers ranging from DSL to ATM and Frame Relay.[21]

These examples (all companies with significant reciprocal compensation revenue) demonstrate that even those that may have benefited significantly from dial-up connections to ISPs in the past recognize that they will soon become obsolete. Purchasers of Internet access increasingly demand the kind of broadband, always-on connections that dial-up cannot provide. Thus, while the ILECs are wrong that CLECs will have inefficient incentives under true forward-looking reciprocal compensation rates, they are also wrong that dial-up is forever. It will soon be gone, and so will reciprocal compensation for ISP-bound traffic.

Sixth, while there have undoubtedly been some fringe firms that have entered solely to arbitrage high reciprocal compensation rates, it is striking that the ILECs can offer

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CLECs," June 14, 2000 (stating that 15 percent of Adelphia's first quarter 2000 revenue was reciprocal compensation).

[20] See Focal Communications Corp. 10-K, March 10, 2000 at 23; Credit Suisse First Boston, "Telecommunications Services: CLECs," June 14, 2000 (stating that 35 percent of Focal's first quarter 2000 revenue was reciprocal compensation).

[21] See Intermedia Communications Inc. 10-K, March 20, 2000 at 2-3; Credit Suisse First Boston, "Telecommunications Services: CLECs," June 14, 2000 (stating that 12 percent of

little evidence of anomalous behavior. Indeed, several of the CLEC practices labeled as "scams" by the ILECs seem in fact to be simply more efficient means of providing service. For example, Verizon points to Brooks Fiber's use of remote NXXs in Maine as an impermissible waste of numbering resources, since Brooks Fiber obtained NXXs solely to provide ISP customers with local numbers in particular rate centers. Verizon Comments at 18-19. However, while Maine prohibited the use of remote NXXs, California has approved them.[22]

In any event, to the extent there are in fact firms that game the reciprocal compensation process, by for example serving only ISPs and not deploying any switches or other facilities, the answer is not the elimination of reciprocal compensation for ISP-bound traffic. Rather, as the Commission stated in the Declaratory Ruling, "issues regarding whether an entity is properly certified as a LEC if it serves only or predominantly

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Intermedia's first quarter 2000 revenue was reciprocal compensation).

[22] Order Instituting Rulemaking on the Commission's Own Motion Into Competition for Local Exchange Service; Order Instituting Investigation on the Commission's Own Motion Into Competition for Local Exchange Service, Decision No. 99-09-029, Rulemaking No. 95-04-043 (Filed April 26, 1995), Investigation No. 95-04-044 (Filed April 26, 1995), 1999 Cal. PUC LEXIS 649, at *24 (Cal. PUC Sept. 2, 1999) ("California Remote NXX Order").

ISPs are matters of state jurisdiction." Declaratory Ruling, ¶ 24. In particular, the Commission concluded that the states are more than capable of "assessing whether and to what extent . . . anomalous practices are inconsistent with the statutory scheme (e.g., definition of a carrier) and thereby outside the scope of any determination regarding inter-carrier compensation." Id. n.78. There is no reason to abandon this approach at this time.

Seventh, SBC argues that reciprocal compensation for ISP-bound traffic causes irrational pricing, since it supposedly causes ILECs to pay too much for terminating service, CLECs to receive too much for terminating service, and ISPs to pay too little for local service. See SBC Comments at 44-46. But these consequences follow only where reciprocal compensation is set above-cost. Of course, to the extent that these problems existed in the past, they were caused by inefficiently high reciprocal compensation rates. There is no reason to think that this should continue in the future.[23]

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[23] SBC's statement that "[e]ven as states reduce reciprocal compensation rates" the problem will continue because of the "phenomenal growth of the Internet" makes no sense. SBC Comments at 44. If reciprocal compensation rates are set based on cost, call volumes it will have no effect.

Eighth, SBC's assertion that applying reciprocal compensation to ISP-bound traffic prevents ILECs from serving ISPs, even when they are more efficient, is also implausible. See SBC Comments at 46. This argument is apparently based on SBC's baseless conviction that forward-looking reciprocal compensation rates grossly overcompensate CLECs. This then causes CLECs to have an unfair advantage in serving ISPs. Of course, as explained, this is simply not the case.

But it is worth further emphasizing that ILECs have lost ISP customers as much because of bad service as anything else, and this is the reason they will likely continue to lose ISP customers even after reciprocal compensation rates are set at efficient levels. The ILECs have consistently neglected their ISP customers, discriminated against them in favor of their own affiliated ISP businesses and generally denied them the logical advantages that CLECs offer, such as collocation near serving switches. The ILECs must recognize that the game of blaming regulation will be over once reciprocal compensation rates are efficient: there is nothing left for them but the hard work of winning customers served by other carriers.

Ninth, Verizon's assertion that applying efficient reciprocal compensation rates to the exchange of ISP-bound traffic will lead to either high local rates or per minute rates

for data lines is clearly wrong. See Verizon Comments at 21-22. If reciprocal compensation is set at efficient levels, there will be no change in ILEC costs associated with ISP-bound traffic.

Tenth, SBC's alarmist argument that application of reciprocal compensation could undermine the U.S. positions taken before the ITU is easily dismissed. See SBC Comments at 47-48. The U.S. has opposed that proposal because it may be adopted without adequate debate and because, as currently drafted, it is so vague and opaque as to be unenforceable.[24] It has also been suggested that this proposal could be used to impose the above-cost international settlement rates on the international exchange of Internet traffic. Id. Opposing such above-cost rates is hardly inconsistent with seeking to establish cost-based rates domestically.

Eleventh, woven throughout the arguments discussed above is the ILEC refrain that local rates do not cover the cost of serving ISP subscribers. This assertion is probably wrong and is in any event irrelevant. The ILECs have never offered credible evidence to support the supposed ISP revenue shortfall. Indeed, their massive revenues from second line sales (which produce close to 100% incremental profit, since the ILECs have generally

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[24] See "ITU Study Group Settlement Rate System For Internet," Communications Daily (Apr. 24, 2000).

recovered the costs of unused second lines long ago) combined with revenues from other overpriced services in all likelihood make the ILECs more than whole. It is therefore no surprise that the Commission was forced to conclude in the Access Charge Order, "[w]e are . . . not convinced that the nonassessment of access charges results in incumbent ISPs imposing uncompensated costs on incumbent LECs." Access Charge Order, ¶ 346.

But again, reciprocal compensation is irrelevant to this debate. The ILECs complain that they pay per-minute reciprocal compensation charges but generally charge ISP customers flat monthly rates. However, so long as efficient rates are set, the ILECs will only pay CLECs to cover the costs ILECs avoid when CLECs terminate ISP-bound traffic. That is, where efficient reciprocal compensation rates have been implemented, the ILECs incur the same per-minute ISP dial-up costs regardless of whether the traffic terminates on ILEC networks or on CLEC networks. Even if the Commission were to eliminate reciprocal compensation for ISP-bound traffic, the CLECs would stop serving the ISPs, the ISPs would return to the ILEC network, and the ILECs would still experience the same purported shortfall that exists today. In short, the Commission's admonition in the Access Charge Order, applies as much to this proceeding as it does to the access charge context: "To the extent that some intrastate rate

structures fail to compensate incumbent LECs adequately for providing service to customers with high volumes of incoming calls, incumbent LECs may address their concerns to state regulators." Access Charge Order, ¶ 346.

It should also be emphasized that the ILECs' claim that the exploding growth of the Internet will only exacerbate problems caused by reciprocal compensation is again misleading. Internet use is indeed growing. But if efficient reciprocal compensation rates are implemented, reciprocal compensation will have no effect on ILEC costs associated with such increased usage. Furthermore, it should be noted that a very significant percentage of Internet traffic is carried over dedicated lines, especially to and from businesses. Also, while there is significant dial-up usage, dial-up will eventually be replaced as a means of accessing the Internet by broadband connections.

For all of these reasons, the policy arguments raised by the ILECs cannot support the elimination of reciprocal compensation for ISP-bound traffic. Such a policy would not, as SBC asserts, lead to efficient outcomes. It would simply lead to the elimination of competition in the provision of local service to ISPs. The ILECs would keep their current low ISDN PRI rates in place, since they can recover the cost of terminating ISP traffic from ISP subscribers. If CLECs were denied the right to collect

reciprocal compensation, they could only serve ISPs profitably by charging the ISPs for transport and termination. This would price the CLECs out of the market. Moreover, if a CLEC were to win an ISP, the ISP would end up subsidizing the ILEC because it would be paying for transport and termination costs that the ILEC would avoid.

Nor is there any merit in SBC's proposal that the Commission establish a cap of 2:1 above which traffic is presumed to be Internet and non-compensable. SBC Comments at 54. Such a cap would obviously arbitrarily limit the extent to which ISPs have competitive alternatives. It is based on the same flawed premise as the elimination of reciprocal compensation: that forward-looking reciprocal compensation prices create inefficient incentives.

In addition, TWTC's experience is that many kinds of customers other than ISPs receive far more traffic than they originate. For example, many of TWTC's non-ISP business customers purchase in-bound PRIs to obtain access to corporate LANs in the same local calling area. This kind of service is purchased by law firms, hospitals, consulting companies, and many other kinds of businesses. Moreover, some companies, like large electric utilities, subscribe to regular voice lines dedicated to customer service, and again these lines exhibit high termination

to origination ratios. As a result, even in the absence of ISP-bound traffic, TWTC's terminating to originating traffic ratio would likely exceed 2:1. For example, during the months of June and July of this year, TWTC's terminating to originating ratio for local traffic (excluding ISP-bound traffic) in the Ameritech and Cincinnati Bell regions was approximately 24 to 1.[25] Thus, if TWTC is representative, there is no basis for presuming that traffic in excess of a 2:1 ratio of termination to origination is ISP-bound traffic.

Moreover, the ILECs strongly imply that carriers with imbalanced terminating to originating traffic flows must be serving only or primarily ISPs. But this is untrue. For example, ISPs comprise only approximately ten percent of TWTC's customers. That number would drop to zero, however, if TWTC could not recover the costs of terminating traffic to ISPs.

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[25] This ratio covers only the old Ameritech and Cincinnati Bell regions since those were the only markets in which TWTC has been able to collect reliable data. TWTC serves Milwaukee, Columbus, Indianapolis and Cincinnati in those regions.

IV. CONCLUSION

For the reasons described herein, the Commission should rule that Section 251(b)(5) applies to the exchange of ISP-bound traffic and that the same price level and price structure should be adopted by states for all traffic subject to Section 251(b)(5).

Respectfully submitted,

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ATTORNEYS FOR TIME WARNER COMMUNICATIONS HOLDINGS INC.

August 4, 2000

EXHIBIT

DECLARATION OF DON J. WOOD

1. My name is Don J. Wood. My business address is 914 Stream Valley Trail, Alpharetta, Georgia 30022. I am a principal in the firm of Wood & Wood, an economic and financial consulting firm. I provide economic and regulatory analysis of the telecommunications and related “convergence” industries, with an emphasis on economic policy, development of competitive markets, and cost of service issues.

2. I received a BBA in Finance with distinction from Emory University and an MBA with concentrations in Finance and Microeconomics from the College of William and Mary. My telecommunications experience includes employment at both a Regional Bell Operating Company ("RBOC") and an Interexchange Carrier ("IXC"). I was employed in the local exchange industry by BellSouth Services, Inc. in its Pricing and Economics, Service Cost Division. My responsibilities included performing cost analyses of new and existing services, preparing documentation for filings with state regulatory commissions and the Federal Communications Commission ("FCC"), developing methodology and computer models for use by other analysts, and performing special assembly cost studies. I was also employed in the interexchange industry by MCI Telecommunications Corporation, as Manager of Regulatory Analysis for the Southern Division. In this capacity I was responsible for the development and implementation of regulatory policy

for operations in the southern U. S. I then served as a Manager in the Economic Analysis and Regulatory Affairs Organization, where I participated in the development of regulatory policy for national issues.

3. I have testified on telecommunications issues before the regulatory commissions of twenty-eight states, Puerto Rico, and the District of Columbia. I have also presented testimony regarding interconnection and cost of service issues in state, federal, and overseas courts, before arbitration panels, and have presented comments to the FCC. To date, I have participated in over forty arbitration proceedings in which the rates for reciprocal compensation were at issue, and in over twenty-five proceedings subsequently undertaken by state regulators to establish permanent rates for reciprocal compensation (and the underlying UNEs) to replace interim rates adopted in arbitrations.

4. I have prepared this declaration at the request of Time Warner Telecom ("TWTC") in order to respond to the declaration of William E. Taylor on behalf of Verizon Communications, as well as arguments presented by SBC Communications.

Response to Taylor Arguments

5. I am responding to three broad claims made by Dr. Taylor:

(1) An economic review of the flow of cost causation associated with a call to an ISP indicates that the ISP and its customer become the "cost causers" in a way that supports the suspension of reciprocal compensation for these calls, but only these calls.

(2) The costs incurred by CLECs to terminate calls made to ISPs are less than the cost that would be incurred to terminate a comparable call to a non-ISP end users.

(3) The application of reciprocal compensation to calls made to ISPs creates, through various methods, harm to economic efficiency.

6. When examined in detail, each of Dr. Taylor's claims are revealed to be unsupported conceptually or factually.

Response to Claim No. 1: An economic review of the flow of cost causation associated with a call to an ISP indicates that the ISP and its customer become the "cost causers" in a way that supports the suspension of reciprocal compensation for these calls, but only these calls.

7. In paragraphs 14 through 20, Dr. Taylor describes various call scenarios intended to illustrate call causation. While I agree in principle that cost causation is relevant to the question before the Commission, and specifically that total societal welfare is maximized when cost causers are responsible for the costs they incur, I disagree with Dr. Taylor's assertion that the flow of cost causation in a local telephone call is dependent in any way on the identity of the calling or called party.

8. The application of the basic economic principles upon which Dr. Taylor and I agree seems clear enough in the current context. If a subscriber to Verizon's local exchange service picks up the phone and initiates a call to another subscriber to Verizon's service, that caller has caused Verizon to incur both originating and terminating costs. If that same subscriber initiates a call to a subscriber to a CLEC's service, that caller has caused

Verizon to ultimately incur the costs of both call origination and termination. Because of a contractual arrangement (the interconnection agreement between the two carriers), the CLEC agrees to accept responsibility for the call brought to it and to deliver it to the called party of Verizon's customer's choosing. The call has then been completed and the CLEC has then incurred the cost of call termination. At that point, it is meaningful to say that, as in the first example, the calling party has caused the costs of both call origination and termination to be incurred by some carrier. In the first intra-network example, Verizon incurred both costs; in the second inter-network example, Verizon incurred the origination cost and the CLEC incurred the termination cost. Since Verizon brought the traffic to the CLEC in order to provide a service to its customer, Verizon causes the CLEC to incur – if it is to meet is obligations pursuant to the interconnection agreement – the cost of call termination. When Verizon then compensates the CLEC, through the payment of reciprocal compensation, for completing the call, it incurs the cost of call termination caused by its subscriber and then finds itself in exactly the same position that it was in when the subscriber initiated a call that stayed on the Verizon network.

9. The same logic works in reverse. If a CLEC subscriber initiates a call to a subscriber served by Verizon, the CLEC customer – by the act of making the call -- will cause the costs of call origination and termination to be incurred by some entity. By taking the call to Verizon and expecting it to be delivered pursuant to the interconnection agreement, the CLEC causes Verizon to incur the cost of call termination. By paying Verizon the

reciprocal compensation rate, the CLEC incurs the cost of call termination caused by its customer.

10. This flow of causation is straight-forward, reciprocal, and – most importantly – *completely independent of the identity of the calling and called parties.* This last characteristic is where I disagree with Dr. Taylor. At paragraph 17 of his declaration, he argues that it is necessary to first know the identity of the calling and called parties, and any other business relationship that these entities may have, in order to determine cost causation. As I understand his argument, when a residential or business subscriber calls a residential subscriber, the flow of cost causation is as I have described it above. When a residential or business subscriber calls a business subscriber, the flow of cost causation is as I have described it above. When a residential or business subscriber calls a business subscriber with which it has a "customer-supplier" or "direct commercial" relationship, Dr. Taylor asserts that the flow of cost causation evolves because the subscriber and the called party mutually benefit from the direct commercial relationship. Because of that mutual benefit, Dr. Taylor asserts, the call becomes akin – in terms of cost-causation – to a toll call carried by an IXC.

11. In the evolved case of a call to an ISP, Dr. Taylor argues that the ISP's customer is the cost causer and that the ISP should be responsible for compensating the LECs (ILEC and CLEC) for the costs they incur when carrying the call. Dr. Taylor is half right in this regard, but for the wrong reason: the ISP's customer *is* the cost causer; not because it is

the ISP's customer, but because it is Verizon's customer making a telephone call. The calling party is not buying telephone service from the ISP, it is buying that service from Verizon. The costs at issue here are those associated with the use of that telephone service. It is the cost of the service being provided by Verizon, not the ISP, that is at issue. It is simply not meaningful to assert that the ISP is responsible for the costs associated with the service that the subscriber is obtaining from Verizon, especially when the subscriber is paying Verizon, and not the ISP, to provide that service.

12. There are two simple ways to look at the problem that underscore the failures in Dr. Taylor's logic. First, Dr. Taylor argues that it is the subscriber's direct commercial relationship, or customer-supplier contract, with the ISP that is causing the cost at issue. It would follow, then, that if the subscriber failed to live up to its side of the contract and did not pay its bills to the ISP, Verizon would have cause to disconnect that subscriber's telephone service. That clearly does not and should not happen. In reality, the costs at issue are those associated with a telephone call, and the contract (and customer-supplier relationship) for telephone service is between the subscriber and Verizon. If the call is carried by more than one LEC, the interconnection agreement between the LECs that handle the call is the relevant contract. Any contract between the subscriber and an ISP, like a contract between the subscriber and any other called party, is simply irrelevant.

13. The second flaw is one of under-inclusiveness. Dr. Taylor states at paragraph 19 that when placing the call to an ISP, the subscriber is "clearly acting as the customer of the

ISP, in precisely the same sense that [it] behaved as an IXC customer" when placing a toll call. Because of the "direct commercial relationship" between the subscriber and the ISP, Dr. Taylor argues, it or its customer becomes the cost causer of the telephone call, and this shift in cost causation justifies the elimination of reciprocal compensation in favor of a meet point billing arrangement which, as a practical matter, equates to bill and keep for this traffic.

14. The obvious problem with this example is that the subscribers to Verizon's local exchange telephone service enter into "direct commercial arrangements" with numerous commercial entities (brokerage firms, flower shops, banks with on-line services, or the oft-mentioned pizza parlor). Dr. Taylor does not argue for the extension of what he refers to as the "LEC-LEC-IXC" paradigm to the subscriber's calls related to each of these other commercial arrangements, however. Verizon (and the other ILECs) are not, as I understand it, arguing that reciprocal compensation should be eliminated for all such customers, but instead are limiting the exclusion to a classification of customer that CLECs have been successful in attracting. Dr. Taylor's argument, if valid, would apply equally to pizza parlors, brokerage firms, and flower shops, and each of these entities would owe – pursuant to the Taylor theory – compensation to the LECs beyond the level of the rates for the telephone service to which they subscribe.

15. Dr. Taylor does not address this apparent over-inclusiveness in his declaration. ILEC witnesses in recent and ongoing state proceedings have done so, however. For example,

in an ongoing investigation before the California Public Utilities Commission, Pacific Bell's economic witness attempted to explain why ISPs, but none of the numerous other identically-situated entities with which the subscriber has a commercial relationship, owe compensation to the LECs.[1] In doing so, the Pacific Bell witness used the example of online banking services. His only argument was that "the bank's online services are incidental to the bank's normal operation." That may be true for some banks, but it hardly addresses the question. For a bank that decides to abandon brick and mortar operations and offer all functions online, this activity would certainly be more than "incidental" to its operations, yet the Pacific Bell witness would only place it in the category with ISPs if it placed "an icon in the corner of its on-line service that let users to the Internet." An obvious question is compelled by this line of reasoning: at what point does an activity become more than incidental to a subscriber's operations? Clearly, the services sold via telephone by the pizza takeout company or the flower shop are not "incidental" to their operations, yet the ILECs, including Verizon, are not arguing that these entities owe additional compensation to the LECs or that calls to them should be exempted from reciprocal compensation. The only distinguishing factor for ISPs is the relative success that ILECs and CLECs have had in attracting them as customers.

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[1] See Direct Testimony of Robert G. Harris, California PUC Rulemaking 00-02-005, July 14, 2000, pp. 14-15.

16. At paragraph 19, Dr. Taylor states that "from an economic perspective, then the party that causes the cost associated with Internet-bound traffic is the originating LEC's subscriber." I agree. Where Dr. Taylor and I disagree is when he begins to argue that the identity of the called party determines the flow of causation; he argues that the originating LEC subscriber that causes the cost is doing so while acting "in the capacity of an ISP customer." What Dr. Taylor does not explain in his declaration is why the same subscriber, when calling to order a pizza, is not likewise acting "in the capacity of a pizza parlor customer." Without such an explanation, Dr. Taylor goes on to exempt all members of his classification of purported cost-causing called parties (those with which the subscriber has a commercial relationship) *except* ISPs.

17. In summary, what Dr. Taylor has actually done is to:

(1) Acknowledge the correct cost causation: "the party that causes the cost associated with Internet-bound traffic is the originating LEC subscriber," then

(2) Attempt to create an exception to that rule – when the called party offers services for sale telephonically, and therefore is engaged in a commercial relationship with the LEC telephone subscriber, the subscriber causes the cost in the capacity of a customer of the called party rather than a customer of the LEC (presumably justifying the elimination of reciprocal compensation for that call), but then

(3) Inexplicably exempts all called parties with such a commercial relationship with the subscriber -- except ISPs – from the exception, even when they are factually indistinguishable from ISPs.

18. At the end of the process, nothing in Dr. Taylor's argument changes the flow of causation outlined in paragraphs 7 and 8 of my declaration. ISPs really are like pizza parlors in this

regard, and the subscribers to a LEC's local exchange service that elect to make calls to either pizza parlors or ISPs cause the originating LEC to incur costs associated with completing the call. Reciprocal compensation, if applied without regard to the identity of the called party, maintains this logical flow of cost causation and provides the correct economic incentives.

Response to Claim No. 2: The costs incurred by CLECs to terminate calls made to ISPs are less than the cost that would be incurred to terminate a comparable call to a non-ISP end users.

19. At paragraphs 24-35 of his declaration, Dr. Taylor recites several standard ILEC claims suggesting that a meaningful method exists for distinguishing calls made to ISPs from other calls terminated by CLECs. The assertion is that calls to ISPs, because of these technical distinctions, cost CLECs less to terminate than calls to other called parties, and by logical extension, that CLECs over-recover their costs when receiving existing reciprocal compensation rates (which were based on the purportedly higher cost of terminating non-ISP calls).

20. The first distinguishing characteristic of ISP-bound traffic claimed by Dr. Taylor is the largely non-controversial one of call duration. Dr. Taylor does not claim that call duration is itself a cost driver, but merely that the rate structure that exists in some interconnection agreements fails to accurately reflect estimated differences in call duration. Dr. Taylor is

correct that call duration only takes on the appearance of a cost driver when a rate structure is established that causes the terminating call setup cost to be recovered over an assumed number of minutes: "set-up costs are spread over more minutes in a longer duration call, so the per-minute cost of a long duration (28 minute) Internet-bound call is smaller than for a short duration (3 minute) local exchange call." While I disagree with Dr. Taylor that the average duration of calls to ISPs has been accurately measured to date, I agree that it is the averaging of the terminating setup costs over an assumed number of minutes that creates the observed problem regarding cost recovery.

21. The issue, therefore, is not one of ILEC or CLEC costs, but one of rate structure. If the call setup cost is recovered through a separate per-call rate rather than being included in the per-MOU rate based on an assumed number of minutes, call duration becomes irrelevant.[2] The average duration of ISP-bound calls (or calls to any identified called party, for that matter) could be 3, 30, or 300 minutes, and the result would be the same: the originating carrier would not overpay, and the terminating carrier would not over-recover its costs. In no way does a difference in call duration support a recommendation to discontinue reciprocal compensation for calls delivered to ISPs.

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[2] Such a rate structure was ordered by the Public Utility Commission of Texas in Docket No. 21982, and is utilized in interconnection agreements between Pacific Bell and CLECs approved by the California Public Utilities Commission.

22. The second distinguishing characteristic of ISP-bound traffic claimed by Dr. Taylor relates to factual assertions regarding line concentration ratios and the nature of traffic-sensitive versus non traffic-sensitive switching functions. Dr. Taylor first makes the conceptual argument that "only those costs that are traffic sensitive – i.e., vary with additional usage – should be recovered in [reciprocal compensation] rates." I agree with this observation.

23. Dr. Taylor then goes on to argue that because CLECs sometimes utilize ISDN Primary Rate Interface ("PRI") facilities to provide ISPs with network access, the CLEC does not incur traffic-sensitive switching costs when terminating calls to the CLEC. Specifically, Dr. Taylor states at paragraph 30 that: "Line CCS costs for Internet-bound traffic, however, are not traffic-sensitive. CLECs that focus on Internet traffic rely on ISDN PRI to serve ISPs and build switches at a concentration ratio of one to one. For those carriers, line CCS costs are fixed with respect to usage. Each line serving an ISP has associated with it dedicated capacity through the switch and increased usage from other lines does not impact the use of the line serving the ISP." Dr. Taylor concludes that for this reason, line CCS costs "are not incremental costs of delivering the ISP calls."

24. Dr. Taylor is simply wrong about this for several reasons. First, the "dedicated capacity through the switch" referred to by Dr. Taylor involves the traffic sensitive elements of the switch (e.g. internal transport links, time slot management equipment, routing/rating functions, and the central processor). As a result, the costs created are properly characterized as traffic sensitive. Second, the path in question through these elements of

the switch creates costs that are incremental, because the capacity used is displaced and unavailable for other call paths, causing these elements of the switch to be measurably closer to exhaust (or the level of utilization at which they will be reinforced). This measurable difference in how close the traffic-sensitive portions of the switch are to exhaust before and after the establishment of the call path in question is what creates the conceptually meaningful cost; a cost that is clearly incremental to the delivery of the ISP call.

25. It is also noteworthy that Telcordia's Switching Cost Information System ("SCIS") calculates the switching resources needed to deliver traffic via ISDN PRI facilities and reports traffic-sensitive costs for this traffic that are higher than the costs reported for calls delivered via voice grade loops.

26. Dr. Taylor also argues that the use of ISDN PRI permits CLECs to design and build switches with "a concentration ratio of one to one." While he is correct that ISDN PRI service is designed with a concentration ratio of 1:1, he is incorrect that such a design reduces or eliminates the costs of call termination incurred by a CLEC. A circuit design with a 1:1 ratio assures that a call path through the switch will always be available. This call path is through the same traffic-sensitive elements of the switch as the call path for other calls, however. Calls delivered via an ISDN PRI contribute to the exhaust of finite traffic-sensitive switching resources, and, by doing so, create incremental costs. The only technical distinction is that the circuit engineered with a 1:1 ratio receives a higher priority

for switch resources than a circuit with a higher ratio. As a result, it may be meaningful to describe the ISDN PRI circuit as more costly than other switched circuits, but there is no factual basis for an argument that the use of ISDN PRI circuits reduces or eliminates traffic-sensitive switching costs.

27. The third distinguishing characteristic of ISP-bound traffic claimed by Dr. Taylor is what he refers to as call direction. Dr. Taylor states at paragraph 31 that "sometimes the TELRICs for originating and terminating local exchange traffic are averaged together to determine a single reciprocal compensation rate, and such a rate would not be appropriate for Internet-bound traffic unless the costs of originating features were removed." As with call duration, this "distinction" is not a characteristic inherent in calls to ISPs but is simply a rate structure issue. If a reciprocal compensation rate is in place that accurately measures the ILEC's cost of terminating switching, "call direction" is simply not relevant.

28. The fourth distinguishing characteristic of ISP-bound traffic claimed by Dr. Taylor is that of load distribution. Dr. Taylor states at paragraph 33 that "it is likely that the load distribution of Internet-bound traffic – number and duration of calls in the busy hour as a percent of total traffic – is different than for other types of calls...Whereas the business day is approximately confined to an 8 hour period with little evening or weekend activity, consumers frequently use the Internet during the evening and weekends." This observation leads Dr. Taylor to the conclusion that "on average Internet-bound traffic

requires less investment and costs per minute to provide capacity to meet peak demand than does ordinary voice traffic."

29. The problem with Dr. Taylor's flow of logic is his implicit assumption that the consumer use of the Internet during the evening and weekends creates an "ISP busy hour" that is different than the switch busy hour. Depending on the mix of business and residence subscribers making calls to a given ISP, the busy hour for these calls could be the same as, or significantly different from, the typical business busy hour. Depending on the mix of customers served by the CLEC, its switch could experience a busy hour at any time of the day. There is simply no basis to speculate that the busy hour for calls to ISPs will be different that the CLEC switch busy hour. Of course, if the ILECs are correct in their assertions that the majority of the traffic on the CLEC switch is bound for ISPs, then it is a near certainty that the ISP-bound calls will occur mostly in the switch busy hour.

30. Dr. Taylor describes in paragraph 34 certain changes that Verizon has made to its switching cost study in order to estimate the cost of terminating an "Internet-bound call." Neither of the two changes that he describes are appropriate. First, he indicates longer holding times were assumed. As described in paragraphs 20-21 of my declaration, call duration is not a cost driver, but simply takes on that appearance when setup costs are averaged over an assumed duration. As a result, this a rate structure, not a cost, issue. The substitution by Verizon of a different assumed average holding time does not solve the problem (at best, it changes the magnitude in an unpredictable direction). Rather than

assume a different holding time, it would be appropriate for Verizon to calculate call setup and per-MOU costs separately, rendering any estimate of call duration unnecessary. Unfortunately, Dr. Taylor's Table 1 indicates that this was not done.

31. Dr. Taylor also indicates that the study was altered in order to substitute an assumption of a 1:1 concentration ratio for the 6:1 ratio that Verizon typically assumes for a POTS line. As described in paragraphs 22-26, however, the traffic-sensitive elements of switching are not displaced in a different way depending on the line concentration ratio; if done correctly, this change should have no impact on the costs that determine the appropriate rate for reciprocal compensation.

32. Dr. Taylor also states that Verizon's costs for tandem switching and tandem trunks were removed from its study, and offers the justification that CLECs typically do not have separate tandem and end office switches. Such an adjustment, if implemented, would penalize CLECs for network efficiency and require them to deploy a network that is as inefficient as the ILEC's in order to receive symmetrical rates for reciprocal compensation. Dr. Taylor also offers the justification that CLECs, through the switches they deploy, do not provide "tandem functions." This is, of course, not the case: CLECs typically offer, through their switches, the opportunity for the ILEC to have calls terminated (to the destination of the ILEC customer's choosing) anywhere within a geographic area comparable to – and often larger than – the geographic area served by the ILEC tandem.

This is the most meaningful definition of tandem functionality, and the only one that is not constrained by historic ILEC decisions regarding network deployment.

Response to Claim No. 3: The application of reciprocal compensation to calls made to ISPs creates, through various methods, harm to economic efficiency.

33. Dr. Taylor argues in paragraphs 37-43 that the application of reciprocal compensation to calls made to ISPs creates "inefficient subsidization." In support of this claim, he states that "the principle of cost causation requires that the ISP customer pay at least the cost his call imposes on the circuit-switched network. Suppose intercarrier compensation for Internet-bound traffic is treated as in the ILEC-CLEC interconnection regime [e.g. reciprocal compensation applies to the calls]. This regime assumes at the outset that the customer initiating the call has paid the originating ILEC for the end-to-end carriage of the call, typically, the per call equivalent of the local call charge. Out of what it receives, the ILEC then pays reciprocal compensation to the CLEC that carries the Internet call to the ISP. This compensation is a per-minute call 'termination' charge which, ideally, should reflect the incremental cost that the ILEC avoids by not having to deliver the call itself."

34. Dr. Taylor then goes on to state that there are two consequences of such a scenario that are created, he suggests, by the application of reciprocal compensation to calls made to ISPs (what he refers to as the application of the ILEC-CLEC interconnection regime): Internet users would be subsidized by non-Internet users, and the ILEC would be faced

with pressure to increase the rates for its retail services, including residential local exchange service. My disagreement with Dr. Taylor is not with his observation that increased Internet usage (and the resulting increase in calls to ISPs) has caused increased network usage costs for both ILECs and CLECs, but with any suggestion that such a problem is created by – or even increased in magnitude by – the application of the reciprocal compensation mechanism to these calls.

35. Dr. Taylor has cast the "problem" to be "solved" by the Commission as one of increased usage costs that cannot be recovered through the existing rates paid by most local exchange end users (many of whom subscribe to flat rate service). The problem here lies less with the basic observations than with the logical leaps taken to reach the conclusions. There is no real debate that network usage has increased, and that at least some portion of this increase can be attributed to increased dialup access to ISPs by local exchange customers. There is also no debate that network usage costs are experienced by both ILECs and CLECs on a per call and per MOU (i.e. usage sensitive) basis, and that many local exchange customers (especially residential customers) subscribe to a flat-rated service . There is absolutely no foundation, however, for a conclusion that the mismatch between costs and rates has been created by the involvement of CLECs or has increased in magnitude because of the involvement of CLECs. There is also no basis whatsoever for the assertion that the application of Dr. Taylor's "LEC-LEC-IXC paradigm" -- effectively bill and keep -- to ISP-bound traffic will provide a solution to this problem.

36. If CLECs did not exist, all ISP-bound traffic would originate and terminate on the networks of the ILECs. As a consequence, the ILECs would incur the cost of both originating and terminating these calls on their networks. The total cost experienced by the ILECs would increase if network usage by its end user customers increased as a result of their calls to ISPs, and for the customers of flat rated local exchange service a mismatch would occur between the way the ILEC's incurred costs and the way they were compensated by customers. In other words, both the "subsidy" of Internet users by non-Internet users and the alleged pressure on ILEC retail rates would exist exactly to the degree that it does today.

37. When CLECs do exist and are involved, some portion of the total ISP-bound traffic originates on the ILEC networks but terminates on the networks of the CLECs. The ILECs incur the cost of originating these calls on their networks, avoid the cost of terminating the calls, and incur a reciprocal compensation obligation. If the reciprocal compensation rates are properly established at a level equal to the ILEC's forward-looking economic costs of call termination, there is no net cost impact when call termination costs are avoided and replaced by reciprocal compensation rates. As a result, the impact on the ILECs of increasing usage by end users calling ISPs is completely unaffected by the fact that some traffic is being handed off to CLECs for delivery to ISPs (or any other called party).

38. The fact that Internet usage has increased, leading to increased usage on the ILEC (and CLEC) networks, is completely unrelated to the existence of CLECs and reciprocal compensation. As a result, there is no basis whatsoever to "solve" the ILEC's purported "problem" by eliminating reciprocal compensation for calls to ISPs, thereby requiring CLECs to incur a portion of the ILEC's costs of serving its end user customers.

39. Equally importantly, Dr. Taylor's proposed solution would not effectively address the problem he identifies. If CLECs are no longer compensated for delivering the calls originated by ILEC customers to called parties that happen to be ISPs, they will have no incentive to serve these customers. The migration of ISPs to the ILEC networks means that while the growth of ISP-bound traffic continues, the traffic will be originated and terminated on the ILEC networks, and the ILECs will incur the costs of both ends of the call. They will be trading cost-based reciprocal compensation for the network costs that these rates are meant to duplicate, and the net effect will be zero. The "problem" associated with the increased usage costs and any mismatch of usage sensitive costs and flat local exchange rates will remain at exactly the same magnitude that would exist if CLECs were delivering the calls to ISPs and the ILECs were paying reciprocal compensation. The existence of CLECs and/or reciprocal compensation is not what creates any cost recovery problem, and the elimination of CLECs from the call flow (a likely consequence of the elimination of reciprocal compensation for ISP-bound calls) will not change the ultimate financial consequences for the ILECs.

40. Dr. Taylor argues at paragraph 44 that if reciprocal compensation is applied to ISP-bound calls, LECs, and especially CLECs would have a diminished incentive to compete to serve residential end users. In reality, the desirability of serving residential customers is not impacted either way by the application of reciprocal compensation rates that reflect the ILEC's forward-looking incremental cost of call termination. The act of trading call termination costs for cost-based reciprocal compensation rates does nothing to change the financial appeal of any group of subscribers. If, as Dr. Taylor suggests, "end users that generate Internet-bound traffic would not pay the full incremental cost of carrying it, LECs would have the incentive to avoid competing for such customers," the incentive is not impacted by the application of reciprocal compensation. In Dr. Taylor's scenario, the LEC serving the below-cost subscriber would not be able to recover its network usage costs even if all calls made by the subscriber were intra-network. If that LEC avoids the cost of call termination and instead is assessed a cost-based reciprocal compensation rate, its ability to recover its costs will not have changed in any way.

41. Dr. Taylor argues at paragraph 48 that "the market for Internet access services should be permitted to evolve freely as consumer preferences and network costs evolve. The choice of technology mix (or mix of technologies) that emerges over time ought not to be affected by regulatory decisions regarding intercarrier compensation." I agree. Dr. Taylor's concern is that the presence of reciprocal compensation rates in excess of the

costs incurred by a CLEC will limit the availability of new forms of dedicated access such as DSL.

42. Dr. Taylor's concern is misplaced. There is no evidence that the availability of DSL and comparable services has been limited by CLECs, or that CLECs have the power in the marketplace to impose such a limitation. Consumer awareness of such services means that no one provider, or group of providers, can restrict customer access; consumers will simply choose to become a subscriber of a carrier that does offer the service. ILECs will continue to have the incentive to move subscribers off the public switched network and onto non-switched services for access to ISPs, and ISPs, including those served by CLECs, will have to respond to their customer's desires for these services. CLECs will have no leverage whatsoever to delay the availability of these services, even if they were to have an incentive to do so.

43. At paragraphs 49-55, Dr. Taylor describes his concerns regarding the potential for arbitrage. He correctly notes that "arbitrage is a frequent response to a market distortion." He is incorrect, however, that any incentives or potential for arbitrage is inherent in the application of reciprocal compensation to calls to ISPs (what he refers to as "the ILEC-CLEC local interconnection regime"). The potential that Dr. Taylor describes exists only if reciprocal compensation rates have inappropriately been established at levels that exceed the ILEC's cost of call termination.

44. Dr. Taylor acknowledges at paragraph 51 that "if the intercarrier compensation rate exceeds the LEC's incremental cost of transmitting Internet-bound traffic, CLECs would have an incentive to create sham traffic solely for the purpose of collecting windfall intercarrier compensation." In support of this assertion, he refers to what is notably the ILECs' only example of such alleged activity: US LEC's interconnection with BellSouth in North Carolina. The key fact that Dr. Taylor neglects to bring to the Commission's attention is that BellSouth had previously explicitly rejected bill and keep, rejected a cost-based rate for reciprocal compensation, and insisted on (and subsequently received from the North Carolina Utilities Commission) reciprocal compensation rates equal to its rates for intrastate access. This charge was eight times the level of BellSouth's reported TELRIC. If Dr. Taylor is arguing that when an ILEC insists on the implementation of a rate that is eight times its cost, competitors will be highly motivated to find ways to change the balance of traffic in their favor, then I agree. The North Carolina circumstances that he describes were not created by the application of reciprocal compensation to ISP-bound traffic, but rather by BellSouth's initial insistence on an excessive rate. Dr. Taylor is correct that such a distortion between costs and rates will create the incentive for arbitrage, but is incorrect that the example that he cites supports the elimination of cost-based reciprocal compensation for ISP-bound traffic. Cost-based rates effectively eliminate that incentive, however.

Response to SBC Arguments

45. At pages 32 through 37 of its Comments, SBC makes several factual claims in support of its assertion that CLECs can terminate traffic to ISPs at lower cost than traffic to other end users can be terminated. This "lower cost" assertion is then used as a part of a broader argument that all of the costs that a CLEC incurs to deliver calls to an ISP should, as a matter of economics and policy, be recovered from the ISP. This broader argument relies completely on a transfer of the role of cost causer from the telephone service subscriber that originates the call to the called party (in this case an ISP).

46. In order to address this issue, it is necessary to divide the costs that a CLEC incurs into two categories: (1) those that it incurs to provide service to the ISP as its end user customer, and (2) those that it incurs to meet its responsibilities set forth in an interconnection agreement to accept and deliver traffic originated by the end user subscriber of another LEC. Only this second category of cost is intended to be recovered through reciprocal compensation.

47. SBC asserts at page 32 that "because ISPs receive so much more traffic than the typical end user, and because all of that traffic (unlike local traffic) is one-way traffic, CLECs can and do serve their ISP customers far more efficiently and at far less unit cost." The salient

question then becomes: To the extent any such cost savings are demonstrated to exist, do they relate solely to the cost that the CLEC incurs to serve the ISP as its end user customer (e.g. to provide it with network access, originating usage, advanced features, and service guarantees), or do they relate to the cost that the CLEC incurs to accept and terminate traffic originated by an ILEC customer?

48. SBC relies on a series of factual claims in order to provide the necessary foundation for their assertion that CLECs experience lower costs and should be compensated at a lower rate. First, SBC claims (pp. 32-33) that the fact that CLECs permit ISPs to collocate equipment at their central offices allows the CLECs to avoid "'huge' transmission *costs that are normally associated with the termination of local traffic*" (emphasis added). This is factually incorrect. The costs that are associated with call termination include switching costs and any transport needed to reach that switch; the facility used to connect the called party to the CLEC – whether it be a high volume facility, a POTS copper pair, or a short jumper has absolutely no impact on the costs of switching and interoffice transport. The savings being addressed by the CLECs cited by SBC make it possible for them to provide service to the ISP – as the CLEC's end user customer – but in no way impacts the cost that the CLEC incurs to provide the service of call termination to the ILEC.

49. Second, SBC claims that CLECs experience lower switching costs when delivering calls to ISPs, because ISPs are sometimes served via "trunk to trunk" connections. SBC offers no

factual underpinning for the asserted cost savings, other than the rather glib assumption that the Commission is already aware of this "fact." In reality, as explained in paragraph 26 of my declaration, the ISDN PRI "trunks" that sometimes connect the CLEC and ISP impose a higher traffic-sensitive cost on the CLEC than a simple POTS "trunk to line" connection.

50. SBC then quietly makes the unsupported leap that since the CLECs are providing service to ISPs utilizing facilities that take on a "trunk to trunk" appearance, a meaningful cost proxy is the ILEC cost of tandem switching. Not surprisingly, the reported TELRIC for tandem switching is significantly lower (less than half) of the reported TELRIC for end office switching. The similarity between the "trunk to PRI" switching functionality sometimes used when a call is delivered to an ISP and the "trunk to trunk" switching functionality provided by an ILEC tandem bears only superficial similarity; in reality, TWTC, and most other CLECs, are deploying fully functional end office switches. These CLECs could not, and do not, provide service to their customers by deploying the functional equivalent of an ILEC tandem switch. SBC does not (as the other ILECs generally have not) asserted that the ILECs are actually deploying switching with the ability to only provide capabilities comparable to an ILEC tandem; they merely note the superficial similarity of the self-described "trunk to trunk" arrangements and hope that the Commission will conclude that a demonstration has been made regarding the existence of

comparable costs. The similarity is only superficial, however, and CLECs such a TWTC deploy – and incur the cost of – fully functional end office switches. As a result, the ILEC tandem switching cost is not a meaningful proxy of the costs that CLECs incur to terminated calls, whether or not the called party is an ISP.

51. SBC next argues (p. 34) that the originating capabilities of the switch are not needed to terminate calls to ISPs. While this is strictly true, it is misleading: the originating functions of the switch are not needed to terminate calls to any end user, whether or not that end user is an ISP. That a distinction between call origination costs and call termination costs exists is undisputed, but such a distinction in no way implies a distinction between the costs of call termination for ISP versus non-ISP end users. In fact, no such distinction exists.

52. SBC argues (pp. 34-35) that a cost distinction exists because some CLECs may not utilize a switch to terminate such traffic, but instead may utilize any of a number of newly available pieces of equipment designed with some variation of "termination only" capability. The SBC argument fails both conceptually and factually. As a factual matter, CLECs such as TWTC are deploying fully functional end office switches in their network in order to meet the call origination and termination needs of its customers. It would not be appropriate to penalize CLECs who deploy these switches by disallowing the recovery of the costs incurred when the CLEC utilizes its switch to terminate a call originated by an

ILEC customer. Conceptually, although the ILECs present no information that shows that this equipment has actually been deployed or that it operates as they have described, the various equipment described by SBC may represent a lower cost solution for an ILEC or CLEC to handle the termination of certain traffic (related or unrelated to ISPs). The Commission should not discourage ILECs or CLECs from deploying the most efficient network arrangement possible by implementing a mechanism that would penalize such efficiency.

53. SBC attempts (p. 35) to support its argument that the costs incurred by CLECs to terminate traffic is lower than the cost incurred by SBC to terminate all traffic by referring to a cost study presented by SBC in Texas. In footnote 69, SBC acknowledges that "the Public Utility Commission of Texas held in its Arbitration Award that this was not a TELRIC study and could not be used to justify differentiating ISP-bound traffic and voice traffic for costing purposes." SBC then goes on to attempt to provide spin to what it refers to as a "somewhat obtuse statement" by the Texas Commission. Far from being obtuse, the stated conclusion of the Texas Commission was clear: the SBC study is not TELRIC, and it does not support a cost distinction between ISP-bound traffic and voice traffic. In fact the results of the SBC study are what SBC claims the costs of a hypothetical CLEC to be, if – but only if -- that CLEC (1) deploys switches that provide the capability to deliver calls to an area comparable only to the area served by a SBC end

office switch, (2) has deployed in Texas a mixture of switch types identical to the mixture in SBC's existing network (including AXE-10s and DMS 10s), (3) serves *only* ISP customers, (4) provides only call terminating (rather than originating) capability, (5) experiences usage volumes equal to SBC's discredited estimate of the volume of ISP-bound traffic delivered by CLECs, (6) experiences call characteristics for those ISP-bound calls equal to SBC's discredited estimate of the current call characteristics of its own ISP customers, and (7) experiences all other costs and expenses at the same level as SBC. Not surprisingly, the Texas Commission found the results of such a study to be inconsistent with TELRIC principles and of no value in showing a distinction in the cost incurred by CLECs to terminate traffic to ISP versus the cost incurred to terminate traffic to other end users. Far from being obtuse, the Texas Commission clearly and completely rejected SBC's flawed study.

54. SBC then goes on to present the broader argument that even if the costs incurred by a CLEC are higher than those shown in the flawed SBC cost study, that the CLEC could nevertheless recover both the costs incurred in providing service to an ISP, and all of the costs incurred to provide the service to SBC of completing calls from SBC customers to that ISP, in the rates charged to the ISP. In other words, SBC is proposing that the cost basis for reciprocal compensation be abandoned in favor of a needs-based test: a CLEC must show that it needs the money in order to be compensated for the call termination

services that it supplies directly to the ILEC and indirectly the ILEC's customers. SBC does so even though there is no precedent in this industry of which I am aware that requires a carrier otherwise fail to recover its costs from end users before receiving payment for a service rendered to another carrier, yet this appears to be exactly what SBC is proposing.

55. In the Texas proceeding cited by SBC, SBC presented the testimony of Edward Wynn and Dr. Robert Harris. Both Mr. Wynn and Dr. Harris presented various arguments in support of SBC's needs-based proposal.

56. Specifically, Mr. Wynn argued at pp. 9-10 of his direct testimony in that proceeding that "[c]ost recovery principles would require that such a determination be made first and that any additional compensation be strictly limited to no more than any demonstrable shortfall, in order to avoid systematic over-recovery of costs." Two elements of Mr. Wynn's assertion need to be addressed.

57. First, he does not identify or explain the "cost recovery principles" to which he is referring . I have spent the past twelve years reviewing cost studies – and the corresponding rate proposals – prepared by each of the Tier 1 ILECs, including SBC companies (well over 350 studies in all). I have never heard an ILEC argue that the recovery of the calculated costs should be contingent on its failure to receive sufficient revenues from other related

(or unrelated) sources. In contrast, the ILECs have consistently argued that the reported costs should be recoverable without regard to other sources of revenue.

58. Second, Mr. Wynn does not explain what he means by the phrase "systematic over-recovery of costs." In the context in which it is presented (as a part of SBC's proposal to limit payment of reciprocal compensation), such an "over-recovery of costs" would occur any time a carrier receives total revenues in excess of total costs.

59. Mr. Wynn goes on (pp. 23-24 of his direct testimony) to explain how his theory would work in practice. CLECs would apparently be required to demonstrate to the Commission that the revenues received from a given ISP are insufficient to permit the recovery of the CLEC's cost of serving that ISP. Mr. Wynn does not explain which costs are to be included in this analysis, however. Clearly, the costs associated with providing network access (local loop or other facilities) should be recovered from the ISP, as they would be for any other end user customer.[3] The costs at issue in the Texas proceeding or the immediate proceeding, however, are not those associated with network access, but instead are directly related to the delivery of a call originated by the end user customer of one LEC to a called party served by a second LEC, including those times that the called party is an ISP. Mr. Wynn was apparently confused about what the CLECs were arguing in

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[3] Of course, in high cost areas it may be appropriate for the network access costs to be recovered through a combination of charges to the end user customer and disbursements from a universal service fund.

that proceeding. TWTC was not (and the other CLECs were not), as they are not in the immediate proceeding, arguing that the costs of providing network access to an ISP should be recovered through reciprocal compensation charges. It is up to each CLEC to recover (or to fail to recover, if it chooses to do so) those network access costs through its rates to the ISP. Instead, the CLECs were seeking in Texas – and are seeking in this proceeding -- reciprocal compensation for its intended purpose: to permit the recovery of the costs incurred when delivering a call when the calling party is the customer of another LEC.

60. One means of testing the reasonableness of a proposal is to consider whether the general principles used to support the proposal in a specific context would also support the application of the proposal in other contexts. In other words, while a given proposal may be specific to a given set of circumstances (in this case and in Texas SBC applies a needs test only to CLECs serving ISPs), the principles underlying and supporting the proposal should hold and continue to make sense in a broader application.

61. The broad application of the SBC theory in the telecommunications industry would result in a number of interesting changes to rates and rate structures, depending on how it intends the proposal to be applied. In Texas, SBC witness Wynn referred to "revenues from the ISPs" in his testimony, but was unclear whether he would require CLECs to make a needs test demonstration for each individual ISP or for their ISP customers collectively. SBC is similarly vague in its Comments.

62. If the test is to be applied at the level of the individual customer, it is my understanding that the general principle supporting the SBC proposal to be the following: carriers should not be compensated for accepting traffic from another carrier and delivering traffic to a called party served by their network unless they have first demonstrated that the revenues that they receive from the called party are insufficient to recover the costs of serving them. In the immediate context, the application of this principle would eliminate reciprocal compensation payments to CLECs for delivering calls to ISPs unless they have demonstrated that their costs of serving the ISP will not be recovered from the revenues that are received (or could be received pursuant to the terms of the access charge exemption) from the ISP.

63. Of course, the delivery of traffic to ISPs by CLECs is not the only possible application of this principle. SBC delivers significant volumes of traffic to called parties delivered to it by other carriers, namely IXCs. If the principle underlying the SBC theory is applied in this context, SBC will only be entitled to receive terminating access charges if it has first met their burden of proving that the revenues that it receives from the called party are less than its costs of providing service. For the majority of business customers and for many residential customers (especially those which live in relatively dense areas, purchase vertical features, or make intraLATA toll calls), SBC will be unable to make such a demonstration of "need." *As a result, a broader application of the SBC theory will inevitably result in the elimination of most terminating access charges currently paid by*

IXCs to SBC. If a cost-based test is applied, SBC should receive terminating access charges as compensation for its costs incurred when delivering the call to the called party, and CLEC should likewise receive reciprocal compensation for delivering calls to called parties, including ISPs. If a needs-based test is applied, CLEC will not be entitled to reciprocal compensation unless they first demonstrate that it is "needed" for a given customer, and SBC will not be entitled to terminating access charges unless it first demonstrates that a "need" exists for a given customer. In addition, any universal service funding that SBC currently receives would need to be revisited pursuant to this theory. It would not longer be sufficient for SBC to demonstrate a need for universal service funding by identifying high cost areas and considering only certain rates charged to those customers; it would be necessary for SBC to demonstrate that each residential subscriber, when all revenues from that subscriber are considered, generates a total revenue that is less than the cost of providing service to that customer.

64. A second alternative is that SBC intends to apply the test at the level of the total revenues derived from all of a CLEC's ISP customers collectively. Broader application of the general principle underlying the SBC theory to classes of customers, rather than individual customers, would have further implications. Terminating access charges would be eliminated for all calls delivered to business subscribers, and would likely be eliminated for all calls made to all residential subscribers. In order to receive universal service funding, SBC must prove that the total revenue that it receives from providing services to

residential subscribers is, in the aggregate, less than the total cost of serving those customers. When this needs test is applied, it is likely that universal service funding will no longer be necessary for SBC.

65. SBC notes at page 37 that when it "asked several CLECs during discovery in the Texas Arbitration proceeding whether they contended 'that revenues that you receive from ISPs do not exceed the TELRIC costs to serve ISPs,' not one CLEC stated that it was making such an argument." SBC is correct, and in fact no CLEC made such an argument in that proceeding. The reason, of course, is that such an analysis is irrelevant to the determination of an appropriate cost-based rate for reciprocal compensation, and only becomes relevant if the SBC needs-based theory is to be applied. Instead of making the argument that SBC wished them to make, the CLECs in Texas argued that end users are best served when telecommunications rates – including rates charged by carriers to other carriers – are established based on cost and in recognition of the roles that interconnected carriers play in ensuring that all calls are delivered to their intended destination.

66. The paradigm shift proposed by SBC in Texas and now in this proceeding – to compensate carriers not for what they do (and the costs they incur) but instead based on whether they "need" the money to serve a given customer or class of customers – will certainly have consequences beyond the limited question of whether CLECs are entitled to reciprocal compensation. Rather than turn the industry on its head in order address a single issue, the Commission should first consider whether that issue can be effectively

addressed within the conceptual framework currently in place. In this case, it can and should be.